Internal Revenue Service
memorandum

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FS:FI&P:MNelson

date: DEC 04 1991

to: District Counsel, Boston CC:BOS

from: Assistant Chief Counsel (Field Service) CC:FS

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subject: Captive insurance company pooling arrangements
[redacted]/[redacted] Proposed Statutory Notice of Deficiency

This memorandum is in response to your request for formal Field Service Advice. We have considered your recommendation that the statutory notice of deficiency to be issued to [redacted] disallow only the portion of the total premiums paid to [redacted]'s captive that were not reinsured with the [redacted] ([redacted]) pool, and we agree with your recommendation in principle. Your recommendation is based on the preliminary report prepared by [redacted] and [redacted], which will conclude that risk shifting exists for [redacted] to the extent risks insured initially with [redacted]'s captive are reinsured with the [redacted] pool. For the reasons set forth below, however, we think the amount of premiums allowable as deductions may be less than the amount ceded to the reinsurance pool.

ISSUE

What portion of the premiums paid by [redacted] to its captive insurance company should be disallowed in the statutory notice of deficiency in light of the pooling arrangement in this case and the decisions in AMERCO v. Commissioner, 96 T.C. 18 (1991), The Harper Group v. Commissioner, 96 T.C. 45 (1991), and Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61 (1991).

DISCUSSION

[redacted]'s captive is a member of the [redacted] pool, along with five other captive insurance companies. It is assumed for purposes of this discussion that each captive is wholly owned by its parent corporation and insures only corporations related to it. Members of the pool are called "participants." Each participant transfers related party risk to the pool ("reinsurance"), and

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each participant takes back a portion of the total risks of the pool, which it then insures ("retrocession"). Estimated premiums are paid into the pool by each participant based on the amount of estimated risk transferred into the pool. At the end of the year, a "final" association premium is paid by each participant, determined by reference to the actual risk of the participant ceded to the pool.

Each participant's share of the risks reinsured from the pool is proportionate to its share of total risks ceded to the pool. For example, if the risk of [redacted] that [redacted]'s captive cedes to the pool comprises [redacted] percent of the total risk of the pool, [redacted]'s captive is obligated to reinsure [redacted] percent of the total risk of the pool. This [redacted] percent of [redacted]'s risk reinsured by [redacted]'s captive would consist of risk originating with [redacted]'s related insureds and transferred to [redacted] by [redacted]'s captive as well as risk transferred by the other participants in the pool.

The liabilities of the participants in the pool are joint; they are not several or joint and several. A participant may withdraw from the pool, or the pool may exclude a participant. Upon termination of a participant's participation, a "termination penalty" is due. The termination penalty is defined as the excess of the participant's losses for the two preceding years over the participant's final association premiums for such years. If a participant's participation is terminated, the termination does not affect the operation of any reinsurance or retrocession agreement for the underwriting period ending at or prior to such termination. This means that a participant remains liable for the exposures of expired periods, which protects the pool from the possibility that a participant will "dump" its adverse business on the pool and then withdraw.

The termination penalty operates only where the participant's losses exceed the premiums paid by the participant. According to the taxpayer's Protest: "In no event would a terminated member be entitled to a refund of premiums paid to [redacted] in respect of [redacted]'s coverage of its risks. The termination penalty is thus limited in scope and is not, in theory or practice, an 'unwind' provision intended to return the parties to their pre-participation positions." For purposes of this analysis, we have assumed that this representation is accurate.

You have advised us that the experts retained by the District have concluded that risk shifting exists for [redacted] and related corporations to the extent [redacted]'s captive has ceded the related party risk to [redacted]. According to your memorandum, the experts' conclusions appear to be based on the facts that (1) the pool is organized upon traditional models, and (2) the experience of the pool suggests that risk transfer took place because some participants realized a profit while others incurred a loss. Based on the experts' conclusions, you recommend that the statutory notice of deficiency not disallow the deductions for insurance premiums paid by the related corporations to [redacted]s captive to the extent they were paid for risk ceded to [redacted]. We agree that the entire premium should not be disallowed as a deduction, but we think the amount allowed should be less than the amount initially ceded to [redacted].

It seems to us that risk shifting exists for the portion of the [redacted]-related risk ceded to [redacted] that is not reinsured by [redacted]s captive because the other participants are obligated to pay losses on those risks and that obligation is not determined by reference to the other participants' loss experience but instead is determined by reference to [redacted]'s loss experience. If the pool were to operate in a way that restricts a participant's obligation to reimburse another participant for losses to an amount determined by reference to the former participant's losses reinsured with the pool or if the "final" premium paid for any particular year were determined by the actual loss (in contrast to risk) transferred to the pool, then it would appear to be a self-insurance arrangement.

The basis of the government's arguments in captive insurance cases has been that insurance only exists to the extent a taxpayer arranges to insulate itself from the financial implications of the occurrence of the insured-against event. [redacted] has arranged for other participants in the pool to pay for a portion of its losses in exchange for [redacted]s obligation to pay for a portion of the other participants' losses in a manner that causes the other participants to bear the risk that the cost of [redacted]'s losses might be greater than the amount of unrelated loss paid by [redacted]'s captive under the pooling arrangement. Thus, [redacted] has shifted some risk. Your recommendation is that the notice of deficiency disallow as a deduction "only the net premiums paid to the captive insurance subsidiary and not 'reinsured' with the [redacted] pool." We do not think [redacted] has shifted risk in a manner proportionate to the amount of risk initially ceded to [redacted], however, and therefore we recommend that you allow as a deduction only the portion of the total premiums that pays for the risk initially placed with the captive that was ceded to [redacted] and not reinsured with [redacted]'s captive under the retrocession agreement.

The information provided in your memorandum to us suggests that risk shifting exists only for the amount of related party risks transferred to the pool that is not reinsured by [redacted]s captive under the retrocession agreement. Because [redacted]s captive reinsures a proportionate share of the entire pool and because the entire pool consists in part of risks of insureds related to [redacted]'s captive, some part of the related party risk originally ceded by [redacted]'s captive to [redacted] has been transferred back to [redacted]'s captive under the retrocession agreement.[1] For example, if [redacted]'s captive cedes related party business to [redacted] and that business comprises [redacted] percent of the pool's total risk, [redacted] is required to reinsure [redacted] percent of the pool's total risk. That [redacted] percent of [redacted]'s total risk is comprised of [redacted]-related risk ([redacted] percent) and unrelated risk ([redacted] percent). Under the retrocession agreement, [redacted]'s captive is now insuring [redacted] percent of the [redacted] percent of the [redacted]-related risk originally reinsured by [redacted]. That is, [redacted] percent of the total related risk originally insured by [redacted]'s captive is back with the captive, in addition to the [redacted] percent that was never reinsured with [redacted]. Thus, under this example, only [redacted] percent of the premiums paid to the captive would be allowed and not the [redacted] percent suggested by your analysis.

We realize that by allowing as a deduction the net premiums representing the cost of insurance actually underwritten by the other members of the pool, we are in effect agreeing that [redacted]'s captive insures unrelated business to the extent it is underwriting the losses of the other participants. Under the analysis above, however, the amount of unrelated business may be less than the taxpayer claims. In any event, we do not think that the presence of unrelated business by the captive causes the related party business to be insurance, notwithstanding our losses in AMERCO, The Harper Group, and Sears. We have recommended appeal in all three cases. (Although notices of appeal have been filed in all three cases, the Solicitor General has not yet authorized any appeal.) Nonetheless, we expect all three cases to be appealed.

CONCLUSION

We recommend that the District allow as a deduction the premiums paid to [redacted]'s captive that represent the amounts paid for risks reinsured with [redacted] that have not been reinsured by [redacted]'s captive.

If you have any questions concerning this matter, please contact Maureen Nelson of this office at (FTS) 566-3345.

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[1] Under the retrocession agreement, all of the risk ceded to the pool leaves the pool to go to the participants. Thus, the existence and operation of the [redacted] retrocession agreement demonstrates that [redacted] merely operates as a brokering mechanism for the reallocation of risk via the reinsurance and retrocession arrangements.

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